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OCTOBER CREDIT OUTLOOK

Persistent Headwinds Fuel Weaker Credit Quality

Economic Update

U.S. manufacturing barely stayed in contraction coming in at 49.0% on the ISM Index in September; up 1.4% over prior month. Any reading under 50.0% is contractionary, marking eleven straight months of declines, but close to expansionary territory. Also, the U.S. added 336,000 jobs in September, which was twice the amount of the consensus estimate. Furthermore, the unemployment rate showed little to no change in September at 3.8% and marks 20 straight months of it being under 4.0%. Additionally, inflation stayed flat at 3.7% from a year ago, continuing its slow down. But we note shelter and food continue to be the culprit for elevating this metric. Overall, we expect inflation to be sticky and the labor market to stay tight with seasonal hires and seasonal spending pushing the manufacturing index back into expansionary territory.

Insolvencies

Third quarter bankruptcies accelerate as 2023 filings are the highest since 2020 and might finish the worst year since 2010 when 827 occurred. Total filings for the first nine months were 516, up 17.0% with the month of September being up 12.0% when compared to September 2022. A deeper dive will show Chapter 11 up 61.0% and small business bankruptcies are up 41.0% for the first nine months with no signs of slowing down. Lower rated companies with variable rate debt are looking more vulnerable as concerns of a recession loom.

State of Corporate Credit

Credit quality is expected to deteriorate further in Q4 given current heads which include persistent inflation, higher for longer interest rates, increasingly burdensome debt service requirements, and slowing economic growth. Overall, the credit picture is still mixed as stronger firms are not as impacted compared to those with high leverage. Nonetheless, the consensus is that 2024 defaults and insolvencies will exceed 2023 as pressure remains.

CURRENT & EVOLVING CREDIT RISKS

Bad Debt

The largest US banks are reporting their highest loan write-offs in years as persistently higher interest rates put borrowers into distress. The top 4 largest US banks are expected to charge off over $5 billion in Q3 according to Bloomberg.

Private Loans

It’s estimated that private debt defaults will climb to 5.0% as high rates batter the market. Private debt acts as a liquidity buffer as companies look to shore up their balance sheet. Roughly, one third of this debt is scheduled to mature in under three years and it’s expected that credit losses will grow within this timeframe.

UAW Strikes

A persistent tight labor market has given unions across the board leverage to demand improved contracts. The automotive union president has decided to target all three automakers with additional weekly increases tied to contract discussions. It has been a month now, and we note an extended strike will likely pressure cash flows and earnings for the big three. Furthermore, the ripple effect to suppliers and to commodities is a greater credit concern as inventory sits idle impacting prices and stretching working capital, which will negatively impact credit quality.